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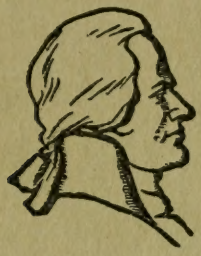
[Modern business Talks]

READING ACCOUNTING RECORDS

The ability to read intelligently an array of figures, to know what they reveal and what they pass over in silence is more than an accomplishment; it is a necessity to the man of business.



MODERN BUSINESS

Talk No. 44

(With Volume 22)

ALEXANDER HAMILTON INSTITUTE
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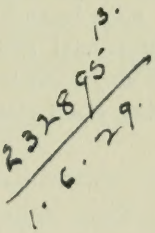
Reading Accounting Records

This Talk, to be read in connection with Volume 22, forms part of READING ASSIGNMENT 44



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NEW YORK

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READING ASSIGNMENT

The current Reading Assignment consists of three parts: (1) this Talk, (2) Chapter XI to the end of Volume 22, "Financial and Business Statements," (3) Problem 22.

Some men read for diversion, others with a serious purpose. But there is compensation in that a serious purpose illuminates whatever it touches. It lightens the hard places and makes seemingly abstruse matters as fascinating as fiction. Those who would understand business thoroly must know the language of business. They must learn to interpret correctly business records. In "Financial and Business Statements" any mystery which may seem to enshroud them is dispelled and their meaning made clear.

Reading Accounting Records

Conclusions based upon proven facts should be clearly distinguished from opinions based upon speculative deductions.—Page 318, Chapter XXII, Volume 22 of the MODERN BUSINESS Text.

As a result of his recent experience in the purchase of a business, Henry Morton has come to doubt the old faith in the absolute veracity of figures. As he puts it: "Figures may tell the truth and nothing but the truth, but they don't always tell the whole truth."

From his point of view, this statement is no doubt justified, for he did not go into the venture without first examining a mass of figures relating to the business. Nor did he feel that he was relying altogether upon his own knowledge in the matter, for the financial statements issued by the company bore the name of a prominent firm of certified public accountants.

A FAIR PROSPECT

The comparative income statements covered a period of three consecutive years and showed a healthy growth and a good margin of profit. During the last year profits had been earned at a rate of $15 per share, and there was every prospect of a continuance of these earnings. It seemed, therefore, to Morton that when he had an opportunity to buy

out the majority owner's interest in the Royal Chemical Company at $125 per share, it would have been folly not to do so. Only the illness of the majority owner—who also was general manager of the company—and the necessity of his removing to another climate for an indefinite stay, made him willing—so he said—to sacrifice his interests in the Royal.

The purchase was made and Morton acquired possession, stepping into the place of the retiring owner as general manager. At first, profits continued as they had in the previous months, but during the third month Morton received a surprise. This came about when it was found necessary to reorder a quantity of a certain important raw material. The price, as a result of war conditions, had risen nearly 300% and it was difficult to obtain the goods even at that price.

A Discovery

Thereupon Morton made a hurried examination of his inventories and found that some of the goods could not then be replaced at any price; others only at a much greater cost than formerly. Then he began to check out conditions that existed under the former ownership, and soon discovered that the increased volume of business and the correspondingly larger earnings were due, not to an unusually able management nor to any special and well-paying contracts, but to the fact that the Royal Chemical Company had been fortunate enough at the beginning of the war to find itself with a very large supply of

raw materials on hand. As market prices of the finished product advanced and old stock was being used, the profits necessarily increased. But these materials were wasting assets, and replacement under new conditions was practically impossible.

An entire readjustment to existing market conditions was found necessary in this case. That is, contracts had to be canceled, the production of certain lines even totally abandoned and new avenues of earnings found. Morton promptly trimmed his sails. He shut down part of his plant, and began investigating possible lines of production to which his plant and equipment could be adapted. That meant, as he found, a considerable remodeling of the plant, but the work was undertaken at once. The Royal Chemical Company is once more busily engaged on important orders, tho in lines considerably removed from the original ones.

Tracing Underlying Causes

Now what was Morton's error in this case? What should he have done that he omitted to do in his investigation of the Royal Company's business?

His error is indeed a common one. His investigation stopped with ascertaining the results of the enterprise, that is, the profits. He proved to his own satisfaction that the profits said to be made were actually made. But he omitted to investigate the causes back of the visible results—the really important thing. Had he pursued his investigation to that point, he

would not readily have been misled by the showing of handsome profits on capital invested.

While in the case just cited the causes did not lie very far back and could easily have been found had there been a disposition to search for them, in other cases they are not so readily discovered, not because the prospective investor is negligent in his investigation, but generally because of his limited knowledge of the factors that enter into the case. Yet it is extremely difficult to analyze and interpret a financial statement intelligently unless one's knowledge of business in general is broad enough to include subjects beyond one's own immediate sphere.

It is not always enough, therefore, to approach the analysis of a financial statement merely with certain definite questions in mind. A safer course is to trace back to its cause every result appearing therein. Often the discovery of a discrepancy in a relatively unimportant item opens the door to other discoveries of a more serious nature. For the same reason, ignorance of underlying conditions may suggest danger where no danger really exists. Thus, some time ago a banker in a small town refused credit to a prosperous specialty house after having examined the latter's balance sheet and income statement. When the specialty house asked the reason for his refusal of credit, the banker at first answered evasively, but when pressed he gave as his reason that the firm's high selling expense indicated a very weak market and that he was afraid the house would fail. Had the banker taken the trouble to investigate the situa-

tion, he would have learned that the nature of the business made a high selling expense necessary in this case. For to market a specialty requires promotion and educational work and not merely—as in the case of most staples—order-taking. Higher-grade salesmen, more extensive advertising and more introductory work are necessary. The banker's narrow viewpoint in this case resulted in the loss of a good customer.

Essential Knowledge

This broader knowledge of business as an essential to intelligent interpretation of financial statements is needed especially by those who are called upon to examine the records of numerous concerns engaged in various lines of business. The credit man, for example, should possess this knowledge. It is not enough that he be able to compare intelligently assets with liabilities, estimate the annual turnover and determine the customer's solvency. If his customers are merchants in country districts he should, for example, know something about crop conditions in their territory, since that may have an important bearing upon the purchasing power and paying ability of the merchants' customers. And tho this information may not be found in the financial statements of his customers, he should be able to read the statements in the light of such conditions.

Moreover, every line of business has peculiarities of its own, and these peculiarities will always be reflected in the statements, so that he who knows them

will see in the statement what to others may be completely hidden.

Two Men Who Knew

Not long ago the treasurer of a large concern had an interview with the president of a leading metropolitan bank with a view to arranging for a considerable line of credit. This banker, tho a model of courtesy, never lost sight of the business in hand. It was his business just then to find out, not only how the affairs of his visitor's business stood, but—more important—how well this treasurer knew the financial details of his own business.

In the midst of a little general talk, the banker suddenly snapped:

"What is your percentage of costs to volume of business, Mr. Green?"

The visitor, without a moment's hesitation, stated the figure with three decimals.

"I thought so in your case," the banker commented, "tho in a business like yours, the cost percentage is usually somewhat lower. And your losses?"

Again the answer came without hesitation. It was less than one-half of one per cent, but the treasurer quoted the exact decimals.

"That is remarkable, and I must congratulate you upon having an efficient credit department. I know a business precisely like yours in which losses considerably exceed one per cent."

Then without referring to any written memorandum the treasurer volunteered information about per-

centage of profit, about various reserves, loans, etc., the banker asking questions and making comments that showed him to be an exceptionally well-informed man.

Looking Ahead

"Now," the banker said, with that suddenness which characterized him, "what are your plans for next year?" But the treasurer could not be taken by surprise. Reaching into his inside coat pocket he drew forth a neatly folded sheet which he spread out before the banker.

"There," he said, "is my estimate of next year's business and a summary of my budgets."

The banker rapidly scanned the paper, then he looked at his visitor. For several moments the two men looked at each other in silence.

"I am going to admit to you," the banker said at last, "that I don't often meet men who know quite so much about their own business as you seem to know about yours. Frequently I have to tell our customers things which they should be able to tell me."

"And I on my part will admit that I have rarely met a banker who knew quite so much about our business as you seem to know. I have been asked questions by bankers that showed they had no idea of the peculiar nature of our enterprise. Were you ever engaged in a similar line?"

"No; but I have always made it my endeavor to know as much as possible about the business of our customers, and this has required a good deal of study

and investigation. I can tell with a fair degree of accuracy what the legitimate banking requirements of a customer are as soon as I see his financial statement. I really had no doubt in your case, but I thought I would find out, if I could, just how tight a grasp you had of your proposition. I shall be glad, Mr. Green, to grant you all the credit for which you have asked, and if you need more come and see me."

Figures and Public Opinion

Not only bankers and credit men, but also the general public may be influenced by financial statements. When sufficiently complete and lucid, such statements are more convincing than a connected argument, however ably presented. The impersonal character of figures gives them an eloquence of their own that is difficult to resist. Thus, when it was found shortly after the opening of the Hudson Tubes which connect New York City with the New Jersey shore that an increase in passenger fares was necessary if the business was to be operated at a profit, it was feared that the traveling public would not take kindly to what it might regard as an arbitrary and unjust demand. Mr. McAdoo hit upon the then unusual plan of taking the public into his confidence. He felt that if the public really believed that the increase in fare was justified, there would be little or no objection to it. Acting upon this belief Mr. McAdoo caused to be published in the daily newspapers the company's balance sheet with full explanations and with a frank statement of the situation.

To many this appeal to the American public's judgment seemed foolish. What railroad had ever cared what the public thought? Weren't they right in charging all the traffic would bear? The public was sure to "kick" in any case!

But McAdoo believed in a "public-be-pleased" policy, and the sequel proved that he was right. When the announced date of the new tariff arrived, the public paid the increased fare without a protest —almost without a murmur. The statements that had been published by the transportation company had convinced the public that the increase was just, and its sense of fair play silenced all objections.

That step inaugurated a new policy on the part of public corporations. Many of them have since profited by taking the public into their confidence by similar means. Nowadays if a car men's strike is about to be declared, the car company hurries into print with its explanation and its figures. If an added franchise tax or a lower rate for public utilities is proposed, the companies affected make their chief appeal to the public. And in such appeal the strongest argument is inevitably the figures presented.

Investigating the Surplus Account

With regard to the item of surplus in the financial statement of a corporation, many a stockholder has discovered that the handsome surplus was not really a surplus at all but instead a withdrawal of assets for purposes of dividends. A weak board of di-

rectors, desiring to make a good showing, may declare dividends out of a surplus that either has been wrongly created or that should have gone into needed expansion or improvement. This is a dangerous practice which inevitably will weaken and perhaps even cripple the business.

For that reason it is important that the prospective investor or lender endeavor to ascertain just what has gone into the surplus account and how much of this amount, if any, is required for reinvestment in the business, so that it may be determined just how much may be safely distributed as dividends. It is not always an easy thing to find this out, however, since it involves a consideration of the peculiar needs of the business, the relation of assets to liabilities, the amount of quick assets needed for current finances, the various classes of assets and liabilities and the various divisions of surplus carried on the books.

Sometimes promoters, when they form a corporation to take over several existing industries, overcapitalize the new company and declare high dividends while stock is being sold, and thus obtain better prices for the stock. That, of course, is mortgaging the future for the benefit of the present—the chief beneficiaries being the promoters themselves, who generally contrive to leave the weakened corporation to the tender care of the new stockholders.

But the opposite of this condition is also found. Sometimes the declaration of dividends is withheld because of the directors' extreme conservatism in the matter of providing for possible future needs of the

business. It is not safe, therefore, either for the investor or the lender to be guided solely by the current dividend rate; he must go deeper and ascertain, if possible, just what are the net earnings of the corporation. Moreover, there may be very sound reasons why a prosperous corporation passes a dividend, even where no such ultra-conservatism exists. Expansion of the business, enlargement of plant and facilities and similar activities, possibly required by a favorable combination of circumstances, may temporarily divert the annual surplus from its usual dividend channels. Nothing short of knowing the real facts back of the statement should satisfy the investor or lender who contemplates an investment or a loan. The financial statement, if properly prepared, will usually reflect the actual condition with sufficient accuracy.

A Dangerous Expedient

Sometimes a corporation which, for a number of years, has been accumulating a reserve for a certain purpose appears suddenly to lose sight of that purpose. The Prentiss Manufacturing Company some time ago did just that thing. This company had outstanding about $350,000 of first-mortgage 20-year bonds upon which interest had been paid for a number of years. The bondholders—most of them local people—knew that the resolution which authorized the issue of these bonds included a decision to create a reserve account for the purpose of withholding from

the yearly profits an amount sufficient to redeem the bonds when they should become due.

As the company was doing a good business in its special field and was conservatively managed, no apprehension whatever was felt with regard to the company's ability to meet its maturing obligations.

At first the effect of withholding profits from distribution by means of this reserve account was to swell the volume of cash on hand. Then arose the problem of finding employment for this idle cash and investment in readily marketable securities followed. Losing sight of the motive for such investments, the management found them rather burdensome and irksome. At length a profitable opportunity to enlarge the factory presented itself. Sales were increasing rapidly and by reason of inadequate equipment production was lagging behind. Increased facilities, it was felt, would mean increased profits, provided the enlargement could be undertaken at once.

Then the question arose. Would it be safe to use $200,000 of the accumulated assets, taking it in part from the cash balance and in part from the sale of securities? The conservative element in the management said "no", and pointed out that the improvements, however valuable, would be fixed and not liquid assets. They were outvoted by those who thought that under existing prices a single year's profits would probably be sufficient to pay back more than half of the amount expended, and it was eighteen months before the bonds would mature. It

would be easy enough, they said, to borrow the remainder at a low rate of interest.

Accordingly the investment was made. Owing to a scarcity of labor and material it took longer than was anticipated to erect the building, while the delays in obtaining equipment and material were still more vexatious. Strikes of workmen complicated the situation and when at length the factory was ready and the labor force provided, a good part of the orders upon which the management had relied for early profits were canceled and were being executed elsewhere.

Thru the lateness of their start and thru other conditions the management was disappointed in its hope of early profits. Thru the tightening of the money market they found that it would have been difficult to have borrowed the anticipated sum except at high rates and the larger demands which their imprudent action had precipitated caused them great embarrassment.

In a moment of weakness they had mistaken the true nature of a reserve account. Unless such reserve is offset by liquid assets it becomes useless for the purpose for which it is created. In the case in point the reserve was intended to meet a maturing cash obligation, and when the obligation matured, the reserve was not available in liquid assets.

The Lines and Between the Lines

In the analysis of a financial statement it is well to bear in mind the remark once made by a success-

ful banker: "It isn't so much what the statement shows as what it doesn't show that determines the real standing of a would-be borrower." And it should be remembered that not infrequently the omissions are designed.

The reading of the present assignment will bring forcibly to the mind of the reader the fact that if financial statements are to mean anything to him, he must read not only the lines but between the lines. There is an old aphorism that figures speak for themselves. So do Frenchmen. But unless you understand French you cannot grasp what the Frenchman is saying. Unless you understand the language of the figures you cannot catch their story. No one can rise from a reading of this assignment without the feeling that there is in the figures a world of meaning, and that he has had glimpses into the new world thus revealed.

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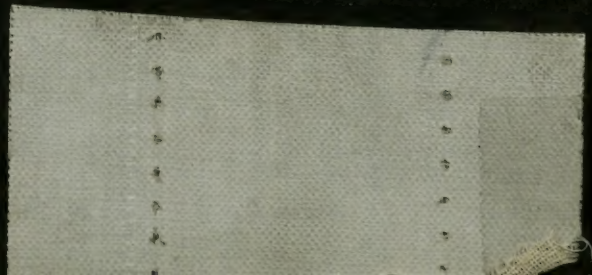

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